United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

76-4162

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

FEDERAL BULK CARRIERS, INC.,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

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Pls

BRIEF FOR PETITIONER-APPELLANT

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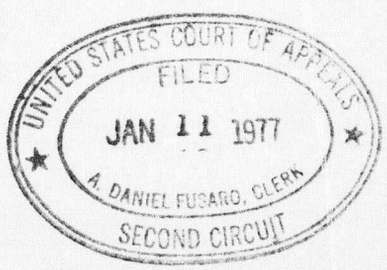

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CITATIONS

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* Reproduced at Exhibit 45 of the Appendix.

PRELIMINARY STATEMENT

This is an appeal by Federal Bulk Carriers, Inc. ("Federal Bulk") from the opinion of the United States Tax Court ("Tax Court") by Judge Arnold Rohm filed May 18, 1976 (R. 71 et seq.).*

Pursuant to statutory notices of deficiency for the calendar years 1962, 1964, 1965, 1966, 1967 and 1968 (R. 1& et seq.), the Commissioner of Internal Revenue (the "Commissioner") asserted Federal income tax deficiencies against Federal Bulk in the aggregate amount of $104,662.47, including $31,030.19 of personal holding company tax assessed under Section 541 of the Internal Revenue Code of 1954, as amended (the "Code") for the year 1966.

All facts in this case were stipulated by the parties (R. 28 et seq.).

In 1961 Federal Bulk and Bessemer Securities Corporation ("Bessemer"), owners of 60% and 40%, respectively, of the securities of Federal Tankers Limited ("Tankers") sold their entire investment in Tankers to Maple Leaf Mills Limited ("Maple Leaf"), a Canadian corporation. At the time, Tankers owned all the shares of stock of Federal Petroleum Carriers Limited ("Carriers"), a Canadian corporation which

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* References to the record in a separately bound Appendix are referred to as "R".

owned the vessel S.T. Federal Monarch (the "Monarch"). After the sale of Tankers, Maple Leaf became the owner of the Monarch. For purposes of this appeal, the parties stipulated that the 1961 transaction was a sale by Federal Bulk and Bessemer, as sellers, to Maple Leaf, as purchaser.

At the time of the sale of its investment in Tankers, Federal Bulk and Bessemer, on the one hand, and Maple Leaf, on the other, agreed to share operating profits and losses of the Monarch for over 13 years following such sale, provided, that such joint operating period would be shortened if the Monarch were sold by Maple Leaf. In 1963, the agreement between Federal Bulk and Maple Leaf to share future operating profits and losses of the Monarch was restructured for technical, but not substantive purposes.

The Monarch was sold subsequently by Maple Leaf in 1965, thereby triggering a determination and settlement of Federal Bulk's share of profits or losses of the Monarch aggregated during the period from 1961 to the date of such sale. The Monarch operated at an aggregate net loss during the period in which Federal Bulk, Bessemer and Maple Leaf shared operating profits and losses, and Federal Bulk's share of such losses was estimated to be $400,776.93 (net of certain gains). Federal Bulk claimed a Federal income tax deduction in that amount for 1965, and claimed a deduction of

$22,240.49 in 1966 for its share of additional losses not finally determined and settled until 1966.

The Commissioner disallowed the deductions claimed by Federal Bulk, and increased its reported taxable income for 1965 by $400,776.93, and for 1966 by $22,240.49. The Commissioner determined that Federal Bulk did not have an operating loss of $385,805.77 for 1965, the amount claimed as a loss for that year, and accordingly disallowed net operating loss carrybacks of $3,308.03, $7,587.18 and $18,128.02 to 1962, 1963 and 1964, respectively. The Commissioner also disallowed the carryover of the unused portion of Federal Bulk's 1965 net operating loss to 1966, 1967 and 1968, respectively, thereby disallowing net operating loss carryovers of $356,382.54, $337,491.25 and $292,666.24 to 1966, 1967 and 1968, respectively. Such disallowances resulted in the Commissioner's determination that Federal Bulk's taxable income for such years should be increased. Based on the disallowance of the net operating loss carryover to 1966, the Commissioner determined that Federal Bulk qualified as a personal holding company under Section 542 of the Code and was thereby subject to the personal holding company tax under Section 541 of the Code for the year 1966.

At trial in the Tax Court, Federal Bulk contended that amounts paid to Maple Leaf which arose from its continuing

interest in sharing the operating profits and losses of the Monarch long after the sale of its investment in Tankers were deductible as ordinary business expenses under Section 162(a) of the Code or as uncompensated losses under Section 165(a) of the Code. The Commissioner contended, and the Tax Court agreed that the amounts paid by Federal Bulk were in the nature of an adjustment to the sale price of the Tankers investment, and were therefore capital losses. The Tax Court did not consider whether the amount of losses incurred by Federal Bulk was $501,684.52 (not $400,776.93) in 1965 and $48,011.81 (not $22,240.49) in 1966, based upon the fact that Federal Bulk, on its Federal income tax return for those years erroneously netted a portion of its ordinary losses against long term capital gain income of $100,907.59 and $25,771.32, respectively, for such years.

On June 24, 1976, Federal Bulk appealed the decision of the Tax Court to this Court (R. 95). Jurisdiction is conferred on this Court by Section 7482 of the Code.

ISSUE PRESENTED

At the time of, and concurrent with the sale of Federal Bulk and Bessemer's investment in Tankers to Maple Leaf, the three parties entered into an executory arrangement continuing

far into the future under which Federal Bulk was entitled to receive payments from Maple Leaf equal to a specified share of the net operating profits of the Monarch (the principal asset beneficially owned by Tankers), and conversely was obligated to pay Maple Leaf an amount equal to a specified share of the future net operating losses of the Monarch aggregated over the same period in the future. The issue is whether the Tax Court erred in holding that amounts actually paid by Federal Bulk to Maple Leaf (as a result of the Monarch's having actual net losses during the period after the sale of Tankers and continuing for 5 years out of a possible 13 years) are not deductible as ordinary losses under Sections 162(a) or 165(a) of the Code, but rather such amounts are capital losses in connection with the sale of the investment in Tankers in 1961 deductible only from capital gains under Section 1211(a) of the Code.

STATEMENT OF FACTS

Background Facts. All of the facts in the case were stipulated by the parties (R. 28 et seq.).

Federal Bulk was incorporated under the laws of the State of New York on November 25, 1955 (R.29, ¶ 1). In 1957, Federal Bulk acquired 60 percent of the outstanding stock of Tankers, a Canadian corporation, for $18,837 (R. 30, ¶ 5).

By September 24, 1959, Federal Bulk also acquired 60 percent of Tankers subordinated notes for $1,299,070. The remaining 40 percent interest in the notes and stock of Tankers was acquired by Bessemer, a domestic corporation (R. 30, ¶ 5).

Tankers was organized to build and charter a 41,246 deadweight ton tanker, eventually named the Monarch. Tankers, in turn, organized Carriers, a Canadian corporation, as its wholly owned subsidiary to contract for the building of the Monarch. The Monarch was built by Davie Shipbuilding Limited at its shipyard in Lauzon, P.Q., Canada. The Monarch was launched on June 19, 1959, and delivered by the builder on September 24, 1959 (R. 30-31. ¶¶ 6-8, 10).

The Monarch was bareboat chartered* by Carriers to Imperial Oil Limited ("Imperial"), a large Canadian oil company (an affiliate of the present Exxon Corporation) for a $1.10 monthly unit deadweight ton charter hire. Imperial then bareboat chartered the Monarch to Tankers at the same charter hire rate. Tankers in turn time chartered** the Monarch to Imperial at a $2.70 monthly unit charter hire. All charters were for a 15 year period ending in 1974 (R. 31, ¶ 11; 74-76).

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* A bareboat charter is a "net-net lease" pursuant to which the lessee assumes all operating expenses and is obligated to pay charter hire even if the vessel is inoperative.

** A time charter is an operating lease pursuant to which the lessor assumes operating expenses.

Eight million dollars of the Can. $11,236,083 cost of the Monarch was obtained from institutional lenders, who required that charter hire payments be pledged as a condition of the financing. Thus, the lenders were assured of a stream of basic charter hire (at $1.10 rate) from Imperial which was sufficient to service the debt. As the holder of the bareboat charter for the vessel which was then in turn time chartered to Imperial, Tankers had to pay all operating expenses (including crew, supplies, water and fuel) of the Monarch. Tankers' profits were earned from the difference between the $2.70 time charter hire and $1.10 bareboat charter hire, after paying such operating expenses (R. 31-32. ¶¶ 12, 13; 77).

Day-to-day management of the Monarch was undertaken by third-party managers (R. 37, 32-35; 77).

Pursuant to a sales agreement (the "1961 Sales Agreement") dated July 31, 1961, Federal Bulk and Bessemer sold their Tankers stock (30,000 shares) and notes (face value Can. $2,095,000) to Maple Leaf for Can. $2,325,000 (R. 33, ¶ 19; Ex. 34). Pursuant to such Agreement, it was contemplated that Maple Leaf would purchase the Monarch from Carriers (which upon the sale of the Tankers stock to Maple Leaf would become the latter's second-tier subsidiary) (Ibid.). Maple Leaf was to assume the obligations of Carriers to the institutional lenders and the vessel was to be chartered by

Maple Leaf to Imperial under the first bareboat charter, by Imperial to Tankers under the second bareboat charter, and by Tankers to Imperial under the time charter (Ibid.). This arrangement permitted Maple Leaf to deduct depreciation on the vessel and interest under the debt obligations for purposes of the Canadian income tax. The sale by Federal Bulk of its Tankers' stock and notes to Maple Leaf was treated as a sale of capital assets for Federal income tax purposes.

At the time of the Tankers sale, Federal Bulk and Bessemer on the one hand, and Maple Leaf on the other hand, agreed to share future operating profits and losses of the Monarch for the next 13 years (the time at which the Imperial charter expired). The 13-year period during which profits and losses were to be shared could be shortened only if Maple Leaf sold the Monarch. Thus, the effect of the transaction was (i) a sale by Federal Bulk and Bessemer of their investment in Tankers, and (ii) an agreement or understanding that the Monarch, now owned by Maple Leaf, a Canadian corporation, would be operated under an agreement whereby Maple Leaf would contribute the vessel and Federal Bulk and Bessemer would contribute financial undertakings -- on a basis of sharing profits and losses pursuant to a formula with respect to the period after the sale.

As a matter of mechanics to protect Maple Leaf in the event of losses, Federal Bulk and Bessemer formed Bessbulk Limited ("Bessbulk"), a Canadian corporation, into which Federal Bulk and Bessemer deposited an initial capital of Can. $1,943,000, being substantially all of the net sale proceeds of the Tankers shares and debentures (R. 34, ¶ 20). Federal Bulk owned 60 percent of the shares and approximately 60 percent of the debentures of Bessbulk; the remaining shares and debentures were held by Bessemer. Pursuant to a commitment agreement, dated July 31, 1961 (R. 34, ¶ 21; Ex. 35), Federal Bulk and Bessemer agreed with Maple Leaf to cause Bessbulk to become party to an indemnity agreement (the "1961 Indemnity Agreement") (R. 34, ¶ 22; Ex. 36), which set forth estimates of revenue that would be derived from, and expenses that would be incurred in operating the Monarch over the remaining term (13 years) of the time charter to Imperial. Federal Bulk agreed that Bessbulk would pay Maple Leaf its annual income to the extent available and necessary to indemnify Maple Leaf in the event the Monarch's actual earnings fell short of projected earnings (the difference between projected revenue and projected expenses). Maple Leaf agreed that at the expiration of the charter to Imperial, or upon the earlier sale of the Monarch (events which terminated the agreement among the parties) Bessbulk would receive 35 percent

of the amount by which the Monarch's actual earnings exceeded projected earnings (R. 35, ¶ 28; also see R. 9, ¶ 5(p) and R. 26, ¶¶ (p), (q)). Conversely, upon termination of the indemnity, the assets of Bessbulk would be paid to Maple Leaf to the extent Bessbulk's current income was not sufficient to cover cumulative deficits in projected earnings (R. Ex. 36).

Under the 1961 Indemnity Agreement, Bessbulk was prohibited from issuing additional shares of stock or amending the terms of its outstanding debentures. It could not engage in the active conduct of any business, but could only invest in certain specified securities (R. Ex. 36, § 8, pp. 13-14).

As of June 20, 1963, Federal Bulk and Bessemer sold their Bessbulk shares and debentures to Maple Leaf pursuant to a sales agreement (the "1963 Sales Agreement"), which continued in effect the arrangement among Federal Bulk and Bessemer, on the one hand, and Maple Leaf on the other, to share future operating profits and losses of the Monarch for the duration of the Imperial charter (R. 36, ¶ 29).

The 13-year period during which the parties shared operating profits and losses of the Monarch was truncated in 1965 when Maple Leaf sold the Monarch to Oswego Unity Corporation, an unrelated third party. Such sale of the Monarch triggered a determination and settlement of Federal Bulk's share of profits or losses (R. 37, ¶ 37). During the period

from July 31, 1961 (the date of the sale of the Tankers stock and debentures), through November 18, 1965 (the date of the sale of the Monarch), actual earnings from the Monarch fell short of the earnings projected in the 1961 Indemnity Agreement (R. 38, ¶ 39; Ex. 44). Federal Bulk's share of these losses was estimated to be $501,684.52 (R. 38, ¶ 39). Moreover, gain had been realized on the liquidation of a portion of Bessbulk's assets which had been held for more than six months. Sixty percent of this gain amounted to $100,907.59 (Ibid.).

A final audit determined that Federal Bulk's share of additional losses of the Monarch was $48,011.81. (R. 39, ¶¶ 43-44). In 1966 additional gain was realized in connection with the contribution to and sale of a deposit required under the Canadian Vessel Construction Assistance Act to avoid recapture of excess depreciation claimed by Maple Leaf in respect of the Monarch (R. 39, ¶ 43). Federal Bulk was required to contribute to this deposit, and its share of the resulting gain was $25,771.32 (Ibid.).

On its Federal corporate income tax return for 1965 Federal Bulk claimed a deduction in the amount of $400,776.93 ($501,684.52 in operating losses netted against capital gains of $100,907.59) for a "loss by indemnification" (R. 4, ¶ 4(a)). On that return Federal Bulk reported a net

operating loss of $385,805.77 (R. 4, ¶ 4(c)), and as a result, filed refund claims for each of the years 1962, 1963 and 1964 on which it claimed net operating loss carryback deductions. It received tentative allowances of $992.41, $2,276.15 and $3,988.16 for those years, respectively (R. 4-5, ¶ 4(d)).

On its return for the year 1966 Federal Bulk deducted $22,240.49 ($48,011.81 in additional operating losses netted against capital gains of $25,771.32) (R. 4, ¶ 4(b)). It also claimed a net operating loss deduction in the amount of $356,382.54 (R. 5, ¶ 4(f). On its returns for the years 1967 and 1968, Federal Bulk claimed net operating loss deductions of $337,491.25 and $292,666.24, respectively (Ibid.).

The Commissioner disallowed as "ordinary losses" the losses claimed by Federal Bulk of $400,776.93 in 1965 and $22,240.49 in 1965, and the resultant carrybacks and carryforwards of such losses; and determined that for 1966 Federal Bulk was a "personal holding company" under Section 541 of the Code (R. 16-23).

Opinion Below. At trial in the Tax Court, Federal Bulk contended that amounts paid to Maple Leaf were deductible as ordinary business expenses under Section 162(a) of the Code, or as uncompensated losses under Section 165(a) of the Code. The Commissioner contended, and the Tax Court

agreed, that the amounts paid by Federal Bulk were in the nature of an adjustment to the sale price of the Tankers investment, and were therefore capital losses. The Tax Court did not consider whether the amount of losses incurred by Federal Bulk was $501,684.52 (not $400,776.93) in 1965 and $48,011.81 (not $22,240.49) in 1966, based upon the fact that Federal Bulk, on its Federal income tax return for those years netted a portion of its ordinary losses against long term capital gain income of $100,907.59 and $25,771.32, respectively, for such years.

SUMMARY OF ARGUMENT

The stipulated facts in this case establish, and require this Court to conclude that (i) in 1961, Federal Bulk sold its Tankers shares and debentures to Maple Leaf under circumstances in which Maple Leaf became the owner of the Monarch, such vessel having been formerly owned and operated beneficially by Tankers; (ii) simultaneously with the sale of Tankers, Federal Bulk (jointly with Bessemer) agreed to be responsible for and to indemnify Maple Leaf during the ensuing 13 year period of the Imperial charter for any future operating losses of the Monarch; (iii) Maple Leaf agreed to pay Federal Bulk a corresponding share of any future operating profits of

the Monarch during such period; (iv) this arrangement was scheduled to terminate more than 13 years after the sale of Tankers to Maple Leaf, but could be brought to an earlier close if Maple Leaf sold the Monarch at an earlier time; and (v) in 1963, the agreements among Federal Bulk, Bessemer and Maple Leaf were restructured, but in a way which did not affect the substance of the relationship among the parties. Thus, Federal Bulk was directly at risk with respect to the operating profits and losses of the Monarch for a period of time extending 13 years beyond the sale of Tankers to Maple Leaf. No matter how one may analyze the legal relationships among the parties to these transactions, the fact (as agreed by the Commissioner in the Stipulation of Facts) is that Federal Bulk was liable to pay a share of the losses of the operations of the Monarch and to receive a share of the profits of the operations of the Monarch. Classically, under such circumstances there should be no question of Federal Bulk's right to deduct such losses from its ordinary income.

Point 1. The Federal Court of Canada, on the basis of precisely the same facts that are in the record in this case, determined that amounts paid by Federal Bulk and Bessemer to Maple Leaf in 1965 and 1966 were not paid to reduce a purchase price.

Point 2. The sale of the Tankers shares and debentures in 1961 was a closed transaction, and payments made by

Federal Bulk to Maple Leaf in 1965 and 1966 to pay for operating losses for which Federal Bulk was liable under its executory agreements executed in 1961 can only result in ordinary losses.

ARGUMENT

POINT I

THE FEDERAL COURT OF CANADA, ON THE BASIS OF PRECISELY THE SAME FACTS THAT ARE IN THE RECORD IN THIS CASE, DETERMINED THAT AMOUNTS PAID BY FEDERAL BULK AND BESSEMER TO MAPLE LEAF IN 1965 AND 1966 WERE NOT PAID TO REDUCE A PURCHASE PRICE AND CONSTITUTED ORDINARY INCOME TO MAPLE LEAF UNDER CANADIAN TAX LAWS.

The basis for the Tax Court's finding against Federal Bulk is summarized on page 22 (R. 92-93) of its decision:

> "Petitioner [Federal Bulk] and Bessemer sold all of their Tankers stock and debentures to Maple Leaf for Can. $2,325,000. Contemporaneously, and it may reasonably be inferred as a condition of that sale, they agreed to guaranty that over a given period the Monarch -- the principal asset held by Tankers and its wholly-owned subsidiary, Carriers -- would produce specified earnings for Maple Leaf. It was in the ultimate settlement of this obligation that the losses whose character is here in dispute were incurred. These losses were thus so intimately tied to the Tankers sale that their character must be ascertained by reference to the original transaction -- the sale of the Tankers stock and debentures. . . . This conclusion is buttressed by the fact that the petitioner [Federal Bulk] and Bessemer were required to set aside the bulk of the proceeds they received from that sale, and it was out of these funds that their obligations under the guaranty were to be

> satisfied. Accordingly, since the sale of the Tankers stock and debentures was a sale of capital assets, the losses incurred by petitioner [Federal Bulk] in 1965 and 1966 were capital losses." [Emphasis added, footnote omitted.]

Thus, as viewed by the Tax Court, the ultimate factual issue in this case is whether amounts paid by Federal Bulk to Maple Leaf in respect of the losses of the Monarch incurred during the period from 1961 to 1965 "were in effect adjustments to the purchase price of the Tankers stock and debentures" (R. 88), the sale of which admittedly occurred in 1961. Precisely this factual issue, involving the same documents in this case, already has been decided by a Canadian court before the instant case went to trial; yet the Tax Court refused to even consider the Canadian case, dismissing it in a footnote on the basis of irrelevant authority (See R. 23).

In Maple Leaf Mills, Ltd. v. Minister of National Revenue, 72 Dom. Tax Cas. 6166 (1972), the issue before the Federal Court of Canada was:

> "[W]hether or not the amount categorized in said Schedule 1 above referred to as 'net revenue decrease' (in Canadian dollars), in the amount of $1,201,079 should be brought into account in computing the appellant's [Maple Leaf's] income for the taxation year 1966, either firstly, as representing the difference in the purchase price of the shares and debentures of Bessbulk between their fair market value and the amount the appellant [Maple Leaf] paid for them, or secondly, as income in another way from the

> business of operating the ship S.T. Federal Monarch; or whether, on the contrary, the said amount should not be brought into account in computing the appellant's [Maple Leaf's] income for the taxation year 1966 because it should be categorized as the statement of the tentative purchase price on capital account of the said shares and debentures of Bessbulk. . . ."
> [Ex. 45, p. 6; emphasis supplied.]

Thus the factual issue in Canada was the precise factual issue in the Tax Court - whether the payments from Federal Bulk to Maple Leaf resulted from operating the Monarch or from adjusting the sale price of a capital asset.

It is inconceivable that the parties could have agreed to adjust a sales price in 1961 given the unknown business risks from the operations of the Monarch which could occur up to 13 years after the sale was consummated; the Canadian court agreed, holding that Maple Leaf must bring such amounts into its operating revenues. Despite this decision on the same facts and presenting the same issue, the Tax Court dismissed the Canadian case under a broad statement that the tax treatment applicable to both parties to a transaction need not be complementary, citing the obvious cases involving payments that are ordinary income in the hands of the recipient, but non-deductible personal expenses or capital outlays in the hands of the payor. Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Gilmore, 372 U.S. 39 (1963). While these authorities may be relevant in certain circumstances, they certainly

are not relevant in this case. Here both courts were dealing with the same factual issue: was there an adjustment in a sales price. This issue is not resolved by reference to precedent in vaguely analogous factual situations which, for example, may hold that wages paid to a carpenter are ordinary income, but a capital expense to the person for whom he performs services, but is resolved by examining the precise facts presented in this case. The conclusion reached by the Canadian court in looking at these precise facts certainly is relevant to this case. To put the relationship of the Canadian case with the Tax Court case in proper perspective, assume that Maple Leaf was a U.S. taxpayer; if it was, the result reached by the Tax Court in this case would be a nonsensical decision because neither Maple Leaf nor Federal Bulk would be entitled to a deduction for the operating losses of the Monarch for a possible period exeeding 13 years. This result is patently preposterous under the Internal Revenue Code because losses (or operating expenses in excess of income) would not be deductible by either party, and it is not made less preposterous by the fact that Maple Leaf is a Canadian taxpayer. Furthermore, the result reached by the Tax Court could lead to a significant revenue loss since, if under the facts there were profits (or income in excess of operating expenses), such profits would not be taxable to either party (except as capital gain).

While the Canadian case may not be binding in the United States, it is entitled to great precedential weight. Further, even if this Court affirmed the Tax Court, under the mutuality provisions of the Income Tax Treaty between the United States and Canada, the Protocol and Regulations* thereunder, Federal Bulk might claim competent authority consideration to abate the deficiencies imposed.

POINT II

THE PAYMENTS MADE BY FEDERAL BULK TO MAPLE LEAF IN 1965 AND 1966 RESULTED FROM FEDERAL BULK'S AGREEMENT TO BE RESPONSIBLE FOR OPERATING LOSSES AND TO SHARE IN OPERATING PROFITS OF THE SHIP "MONARCH" AFTER THE SALE OF TANKERS STOCK IN 1961, AND, THEREFORE, SUCH PAYMENTS RESULT IN ORDINARY LOSSES OR DEDUCTIBLE EXPENSES.

The conclusion reached in the Canadian case -- that there was no adjustment in a sales price between Federal

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* See, e.g., Treas. Reg. Sec. 519.102(a) which provides:

> "The primary purposes of the Convention, to be accomplished on a mutually reciprocal basis, are the application of a limited rate of taxation to certain classes of income derived from within one of the contracting States by residents or corporations of the other contracting State, the avoidance of double taxation, the modification of certain taxation provisions with a view to harmonizing as nearly as may be the taxation principles of the two countries, and exchange of fiscal information complementary to other provisions of the Convention, including those relating to the avoidance of double taxation." [Emphasis added.]

Bulk and Maple Leaf -- is also mandated under United States tax principles. No one questions the fact that Federal Bulk's obligation to pay a share of the Monarch's future operating losses to Maple Leaf was "intimately tied" (R. 92) to the sale of Tankers stock and debentures, in that such obligation was contracted for at the same time as the sale and was a condition for the sale. However, this simplistic conclusion of the Tax Court avoids the real issue in the case, namely, whether the sale of Tankers was a closed transaction in 1961, and the agreement to share future profits and losses, while entered into at the same time, was a separate executory arrangement.

Reduced to its essence, Federal Bulk and the Commissioner stipulated that the transaction between the parties was a sale of the Tankers investment to Maple Leaf for a fixed price in 1961, followed by an open arrangement to share future gains and losses of the Monarch for a period possibly exceeding 13 years after the Tankers sale. Until this case, the Commissioner's categorical position has been to require payments made under an open arrangement such as this to be treated as ordinary profits or losses. There has been no previously decided case, until this one, which has held that an arrangement to share both profits and losses growing out of events occurring after a sale results in an adjustment in the sales

price. On the contrary, the Commissioner has consistently contended that the consideration received in a transaction involving the sale of a capital asset must be assigned a present fair market value; the seller must report a capital gain or loss on the basis of that present value; and the seller must report any consideration received in excess of such value as ordinary income or, if the seller actually receives less consideration (or makes a payment to the buyer), must report such amount as ordinary loss. The Tax Court never addressed this issue,* but merely concluded

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* The Tax Court's failure to consider the main issue in this case may be attributable to its finding - in contravention of the Stipulation of Facts - that Federal Bulk was not entitled to a share of the profits of the Monarch after 1963. After finding that Federal Bulk and Bessemer would be entitled to 35% of the Monarch's profits up to the 1963 sale of the Bessbulk shares and debentures, the Tax Court concluded that such sharing:

> "[W]as in any event eliminated by the 1963 Sales Agreement, which restructured the entire arrangement. According to provisions in that agreement the price Maple Leaf was required eventually to pay for the Bessbulk stock and debentures could not exceed the net worth of Bessbulk's assets plus the amount of the earnings thereon previously distributed to Maple Leaf. Thus, any amounts received by petitioner [Federal Bulk] in excess of its contributions to Bessbulk would be limited to the appreciation in value of the preferred shares, bonds and the like in which those funds were required to be invested and the earnings thereon. On the other hand, the amount of such contributions which petitioner [Federal Bulk] would eventually recoup was at all times subject to being reduced

(footnote continued on next page)

that if one takes into account all of the facts and circumstances here -- the executory contractual arrangements between the parties which controlled the business arrangements

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(footnote continued)

> by its share of the amounts needed to compensate Maple Leaf dollar-for-dollar for the aggregate amount by which the Monarch's earnings over the duration of the agreed period fell short of projected earnings. . . ." (R. 90-91).

This statement of the operation of the 1963 Sales Agreement is in direct conflict with the parties' understanding of that Agreement as expressed in the Stipulation of Facts:

> "Under the 1963 Sales Agreement, the purchase price of the Bessbulk shares and debentures was to be based upon the net worth of Bessbulk, less the 'charter period deduction'. . . . The 'charter period deduction' was determined by subtracting any 'net revenue decrease' from 'net revenue increase' aggregated to the time of expiration of the Imperial charter or the sale of the Monarch. . . . 'Net revenue increase' was the yearly excess of actual earnings of the Monarch over projected earnings. 'Net revenue decrease' was determined, in a year in which there were actual earnings (i.e., a year in which the Monarch did not operate at a loss, but did not meet stated earnings), as the excess of projected earnings over actual earnings; and in a year in which there were actual losses, as the aggregate of projected earnings plus the amount of actual loss. Any distributions by Bessbulk to Maple reduced the amount of 'charter period deduction'". (R. 36-37, ¶ 31).

Accordingly, if the Monarch operated at a profit and generated an aggregate "net revenue increase" -- and therefore a negative "charter period deduction" -- the "purchase price" of the Bessbulk shares and debentures would be increased by a like amount. Thus, contrary to the finding of the Tax Court, under the 1963 Sales Agreement, Federal Bulk continued to have a direct participation in the profits of the Monarch, as well as in its losses, for a period up to 13 years after the sale of Tankers.

(footnote continued on next page)

between them to divide profits and losses of the Monarch for a potential 13 year period -- is an arrangement to adjust the purchase price of the Tankers shares and debentures. This position is untenable under the Commissioner's published Rulings, Treasury Regulations and under numerous judicial decisions.

Revenue Ruling 58-402* provides the general rule that a sale or exchange (or an event, like a liquidation,

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(footnote continued)

Further, the Tax Court appeared to conclude that the Monarch had no realistic chance of producing operating profits which would benefit Federal Bulk:

> "However, the maximum revenue of the Monarch was limited by the terms of the charters to Imperial. Thus, for actual earnings to exceed projected earnings the expenses of operating the Monarch would have to prove less than projected, a prospect hardly shown to have been likely, or realistically anticipated, on this record...." (R. 90)

There is no evidence in the record in this case which indicates that the Monarch could not realistically be operated so as to produce a profit for Federal Bulk. On the contrary, there is much evidence that Federal Bulk sought to bring the Monarch up to profitable levels Managers constantly were being changed in order to find more efficient operators of the vessel (R. 37, ¶¶ 32-36). Indeed, it appears from the record that efforts to achieve profitable operation of the Monarch were becoming successful. Losses of $362,108 and $284,495 in the years ended July 31, 1963 and 1964, respectively, were reduced to $129,482 for the year ended July 31, 1965. Accordingly, whereas the Monarch did in actuality experience losses during the executory period of the contract, the facts do not show that the Monarch was precluded from operating profitably -- a share of which profits would have accrued to Federal Bulk.

* 1958-2 C.B. 15.

which is treated as a sale or exchange) involving a contract which provides for future payments between the parties is to be treated as a closed transaction, with all such future payments being considered ordinary income or ordinary loss transactions to the parties. To hold otherwise would be to legislate broader "installment sale" arrangements than Congress saw fit to provide for by enacting Section 453 of the Code.

Revenue Ruling 58-402 does, however, note that judicial decisions have provided some exceptions to this general rule, and therefore provides that in "rare and extraordinary cases", the sale or exchange will remain an open transaction. The Treasury Regulations issued under Section 453 of the Code reiterate this position. See Treas. Reg. Sec. 1.453-6(a)(2). While Revenue Ruling 58-402 is imprecise as to the meaning of this phrase, it is clear from the cases cited in the ruling that the limited exception of "rare and extraordinary" never has been applied after a sale transaction to an executory arrangement to share future profits and losses as in the present case, especially for 13 years. It has never been suggested that the 1961 Indemnity Agreement and the related agreements in respect of the sale of the Tankers shares and debentures should be characterized as a "rare and extraordinary" case which should be kept open (and

such characterization would have no merit in view of the fact that the parties placed a fixed price on the transaction).

The Tax Court's principal support for its conclusion is Arrowsmith v. Commissioner, 344 U.S. 6 (1952). In Arrowsmith, the taxpayer properly reported certain corporate partial liquidation distributions as capital gains in the years 1937 through 1940. In 1944, a judgment was rendered against the corporation, which the taxpayer was required to satisfy as transferee of the assets of the corporation. Payment of the judgment was held to be treated as a capital loss because the liability of the taxpayer was not based on any ordinary business transaction, but rather involved a liability of the corporation whose assets the taxpayer had received in liquidation. In other words, the taxpayer had to pay over, as transferee, assets which he had received in the liquidation of the corporation. Arrowsmith and its progeny involve adjustments between tranferors and transferees that are based upon the transaction -- not based upon subsequent business operations. The holding in Arrowsmith is clear, and it is equally clear that Arrowsmith has no application to this case. Under Arrowsmith, an adjustment which a taxpayer is required to make in respect of the transactions of a transferor (i.e., the liquidating corporation) will adjust the transaction (i.e., the liquidating

distribution) in respect of which the transferee computed its income tax. In Arrowsmith, since the initial transaction was a capital transaction, the adjustment was capital in nature.

In the present case, however, the parties did contemplate future payments to be made under the 1961 Indemnity Agreement, but not in respect of any adjustments relating to the transferor's activities either prior to or after the sale of the Tankers shares and debentures in 1961. To reiterate, this case involves a sales transaction closed in 1961, and payments based upon the future sharing of profits and losses of the Monarch for over 13 years. Such payments can be characterized as arising out of a joint venture or a guaranty as to projected earnings from the operation of the Monarch, in 1965 and 1966. While these payments were specifically provided for by the parties in 1961, they did not and under the law cannot be considered as relating back to the sale of the Tankers shares and debentures in 1961.

If the Tax Court's decision is not rejected by this Court, Section 453 effectively will have been eliminated from the Code and all cases involving contracts which provide for future contingent payments based upon future events will become "open transactions." Thus, if a transaction is not "open" under code Section 453, under the Tax

Court's decision it may be "open" under Arrowsmith. This result will, in the long run, lead to a loss of tax revenue in that it will turn ordinary income into capital gain and permit a deferral of capital gain income for taxpayers who would not qualify for such treatment under Code Section 453.

With the exception of Duveen Bros., 17 T.C. 124 (1951), aff'd, 197 F.2d 118, cert. denied, 344 U.S. 884 (1952), an adjustment between the transferee and transferor growing out of the original transaction -- and not part of a subsequent business arrangement -- is the common theme of all of the cases cited by the Tax Court in connection with the Arrowsmith doctrine.

In Kimbell v. United States, 490 F.2d 203 (5th Cir.), cert. denied, 419 U.S. 833 (1974), the taxpayer, who had realized capital gains on the sale of two oil and gas leases, made payments to the buyers to settle fraud claims after it was found that wells on the land subject to the leases were illegally slanted. The Court held that such payments constituted a capital loss. Like Arrowsmith, Kimbell involves a payment made by the taxpayer as transferee of payments in the initial transaction, and not as a result of a continuing business relationship between the parties (the sharing of future profits and losses of a business venture). Although the discovery of the alleged fraud was made after the sale had been completed, the alleged fraud itself occurred when

the leases were transferred to the buyers (and, presumably, in the negotiations prior to the sale). Thus, the payment made by the taxpayer in Kimbell, unlike the payment made by Federal Bulk in this case, did not arise out of a business arrangement subsequent to the sale or exchange of the capital assets. Similar results obtained in Estate of James M. Shannonhouse, 21 T.C. 422 (1953); Rees Blow Pipe Mfg. Co., 41 T.C. 598 (1964), aff'd per curiam, 342 F.2d 990 (2d Cir. 1965) (damages paid in respect of breach of warranty of property previously sold not deductible as an ordinary losses); and John E. Turco, 52 T.C. 631 (1969) (expenses voluntarily paid to remedy defective property previously conveyed not deductible as ordinary losses).

In Duveen Bros., supra, the Tax Court held that payments made by a seller of shares of stock, under a guaranty against a redemption of such stock at a price below the sum of the amount paid by the purchaser for the stock plus the dividends thereon received by the purchaser prior to the redemption, resulted in capital losses. Although the actual redemption of the shares in Duveen occurred after the sale of such shares by the guarantor, the Court's analysis of the facts indicates that the guaranty arrangement was based on corporate activities which occurred

prior to the sale of the shares by the guarantor:

> "Prior to the initial sale, Brown Bros. [investment bankers] expressed reluctance to undertake sales of such large blocks of stock without arranging for some protection of its clients against possible loss in the event of an early redemption of the stock by [the company] under its option to redeem the stock at the redemption price of $11 per share." 17 T.C. at 126.

Thus, although Duveen may be an abberation from the general application of the Arrowsmith doctrine, its deviation from the general rule as to the inapplicability of Arrowsmith would appear to be the result of the unique fact pattern involved in the case.

Duveen may be viewed as a case involving a warranty, where the seller's actual liability would, given the imminent "call" on the stock by the corporation after the initial sale, be fully and finally determined shortly after the sale. Furthermore, the parties in Duveen were not engaged in a continuing business relationship, but rather were concerned with a single specific event whose occurrence was apparently imminent at the time of the sale of the stock.

In contrast to Duveen, this Court should consider Carl Hess, 7 T.C. 333 (1946), in which the taxpayer sold certain shares of stock which he guaranteed against loss of value for a 10-year period. The Tax Court held that a payment made on the guaranty was deductible as ordinary

loss. Further, the Commissioner has acquiesced in the result of this case, 1946-2 C.B. 3. The same result was reached on similar facts in R. W. Hale, 32 B.T.A. 356 (1935), acq., 1954-2 C.B. 4, aff'd on other issue, 85 F.2d 819 (D.C. Cir. 1936).

None of the exceptions to the general rule that a sale or exchange is a closed transaction, and that future payments (or recoupments) are ordinary income, applies to the facts in the instant case. The sale of the Tankers shares and debentures by Federal Bulk and Bessemer to Maple Leaf was a complete and closed transaction which vested title of the shares unconditionally in Maple. The contract between Federal Bulk and Maple Leaf was not a "rare and extraordinary case." The Arrowsmith case does not apply, since there was no event which caused the parties to adjust specifically the sales price which Maple Leaf paid for the Tankers shares and debentures. Finally, the lack of a representation or warranty, the fact that each of the parties were potentially liable for payments under the 1961 Indemnity Agreement and the subsequent sharing of profits and losses between Federal Bulk and Bessemer on the one hand, and Maple Leaf on the other, make Duveen and the Arrowsmith line of cases totally inapplicable. In fact, it may even be improper to analyze this case under the "closed transaction" line of cases, since the sale of

Tankers was a totally distinct transaction from the agreement to share the operating profits and losses of the Monarch. If the Arrowsmith reasoning were applicable here, the Canadian court would not have found against Maple Leaf when it tried to claim that payments from Federal Bulk were an adjustment of a sales price.

Accordingly, the payments made by Federal Bulk to Maple Leaf in 1965 and 1966 are ordinary in nature, and are deductible from its taxable income in the years paid.

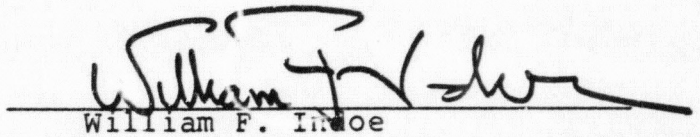
CONCLUSION

For reasons set out above, this Court should reverse the decision of the Tax Court, and determine that "loss by indemnification" deductions claimed by Federal Bulk in the amount of $400,776.93 for 1965, and $22,240.49 for 1966 constitute ordinary deductions under Section 162(a) or 165(a) of the Code. In addition, this Court should determine that Federal Bulk is entitled to proper relief based upon the fact that on its Federal income tax return for years 1965 and 1966, ordinary losses in the amounts of $501,684.52 and $48,011.81, respectively, were erroneously netted against

long-term capital gain income of $100,907.59 and $25,771.32, respectively, for such years.

January 11, 1977

Respectfully submitted,



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CERTIFICATE OF SERVICE

It is hereby certified that the service of the Appellant's main Brief has been made on counsel for Respondent-Appellee on this 11th day of January, 1977 by mailing 4 copies thereof in an envelope, with postage prepaid, properly addressed to him as follows:

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5-13512

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